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IN THE

SUPREME COURT

OF THE

UNITED STATES.

Nos. 163, 164 and 165.

No. 163.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,
vs.
WILSHIRE OIL COMPANY, INC.

No. 164.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,
vs.
RANDINI PETROLEUM COMPANY.

No. 165.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,
vs.
WILSHIRE ANNEX OIL COMPANY.

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

BRIEF FOR RESPONDENTS IN OPPOSITION.

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August 15, 1938.

Parker & Baird Company, Law Printers, Los Angeles.

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*Italics supplied throughout unless otherwise indicated.

Opinions Below.

The opinion of the Board of Tax Appeals [R. 54-56] is reported in 35 B. T. A. 450. The opinion of the Circuit Court of Appeals is reported in 95 Fed. (2d) 971. There are no reported opinions in Nos. 164 and 165 and by stipulation [R. 81] the records therein have not been printed. Accordingly this brief will deal only with No. 163.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered April 1, 1938. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Counter-Statement of Question Presented.

Should the amount of percentage depletion otherwise allowable for the taxable years 1929 and 1930 be reduced pursuant to a Regulation adopted for the *first* time in 1929, where the taxpayer, in accordance with a binding election made in 1925 in reliance upon the uniform administrative construction of identical language of the Revenue Acts of 1921 and 1924, was *required* by the Treasury in the later years to charge off "intangible drilling and development costs" incurred in drilling oil wells.

Throughout almost its entire length, the petition conveys the false impression that respondent, *at the time of filing its returns here involved*, exercised an election to deduct its development expenditures in determining taxable net income instead of capitalizing them. (Petition, pp. 2, 4, 6, 7, 8, 9.) As the record shows, the respondent made its election in this regard in its return for 1925 [R. 53], over

three years before the Commissioner made his "about-face"[1] and *first* promulgated the portion of Article 221 (i) upon which he now relies. This 1925 election bound the respondent "for all subsequent years." Art. 243, Regs. 74; Art. 223, Regs. 69.[2]

Statutes and Regulations Involved.

Revenue Act of 1928, c. 852, 45 Stat. 791:

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

* * * * * * * *

"(1) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

* * * * * * * *

"SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * * * * *

"(b) *Basis for depletion.*—

* * * * * * * *

---

[1]To borrow from Circuit Judge Swan in *Bliss v. Commissioner*, 68 Fed. (2d) 890, 893, affirmed *Helvering v. Bliss*, 293 U. S. 144.

[2]See also Note 1 on page 7 of the petition.

"(3) *Percentage Depletion for Oil and Gas Wells.* —In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

Treasury Regulations 74, promulgated February 15, 1929, under the Revenue Act of 1928:

"ART. 221. *Depletion of mines, oil and gas wells; depreciation of improvements.*—Section 23(1) provides that taxpayers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. See section 114 and articles 241 and 611 with reference to the basis for computing depreciation and depletion.

"The essence of these provisions of the Act is that the owner of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either the cost of his property, or the value of his property on the basic date plus, in either case, subsequent allowable capital additions (see articles 242 and 243), but not including land values for purposes other than the extraction of minerals. (But see section 114(b)(3) and article 241.)

* * * * * * * *

"When used in these articles (221-257) covering depletion and depreciation—

* * * * * * * *

"(f) 'Operating profit' is the net amount received from the sale of minerals before depletion and depreciation are deducted. It is distinct from net income, as defined in section 21.

* * * * * * * *

"(i) 'Depletion allowance based on the income from oil and gas wells': The deduction for depletion based on the income from oil and gas wells shall not exceed 50 per cent of the net income of the taxpayer, computed without allowance for depletion, from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to the income from the property. The phrase 'net income of the taxpayer (computed without allowance for depletion)' means the gross income from the sale of oil and gas less the deductions in respect to the property upon which depletion is claimed, including overhead and operating expenses, *development expenses (if the taxpayer has elected to deduct development expenses)*, depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. If the oil and gas are not sold on the property but are manufactured or converted into a refined product or are transported from the property prior to sale, then the gross income shall be assumed to be equivalent to the market or field price of oil and gas before conversion or transportation. Depreciation, taxes, and such expenses as overhead (which can not be directly attributed to any particular property) shall be allocated on the basis of the ratio of the number of units produced from the property on which depletion is claimed to the total number of units produced from the operating division in which the property is located. In cases where the taxpayer, in addition to producing oil and gas, engages in additional activities such as operating refineries and trans-

portation lines, depreciation, taxes, and such expenses as overhead which can not be directly attributed to any specific activity, shall be allocated to the production of oil and gas on the basis of the ratio which the operating expenses and development expenses (if the taxpayer has elected to deduct development expenses) directly attributable to the production of oil and gas bear to the taxpayer's total operating expenses and development expenses."

"ART. 241. *Depletion in the case of oil and gas wells.*—Under section 114(b)(3), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. (See article 221(i).) In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, 'the property', as the term is used in section 114(b)(3) and this article, refers to the separate tracts or leases of the taxpayer."

"ART. 243. *Charges to capital and to expense in the case of oil and gas wells.*—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a *development expense* or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reason-

able allowance for depreciation. The cost of drilling non-productive wells may at the option of the operator be deducted from gross income as a development expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells. *An election once made under this option will control the taxpayer's returns for all subsequent years.* Where deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return."

Counter-Statement.

The facts may be summarized (as they were by the Commissioner in the Circuit Court of Appeals) as follows [R. 48-53]:

Respondent is a California corporation engaged in the business of producing oil and gas from various properties located in southern California [R. 48].

During the years 1929 and 1930, the respondent operated some eleven or twelve oil and gas properties. However, the controversy here is limited, for the year 1929, to the Peterson, Baker and Crawford leases. For the year 1930 the controversy concerns those three properties and the Buckbee lease [R. 48-50].[3]

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[3]Actually only *two* properties, the Peterson and Baker leases, are involved in the year 1930—see note 6, *infra*, p. 10.

In determining the deficiency for the year 1929, the *Commissioner allowed* as a deduction for the depletion of the three properties the sum of $111,962.24, which sum he arrived at as follows [R. 52]:

Gross income from the three properties		$1,001,375.17
Deductions:		
Production expense	$171,399.03	
Development expense	606,051.66	
Total expense		777,450.69
Net income of the taxpayer (computed without allowance for depletion) from the property		223,924.48
Percentage depletion limited to 50% of the net income from the property		111,962.24

In determining the deficiency for the year 1930, he found that the taxpayer sustained a loss from the operation of the four properties, and hence *allowed no deduction for depletion*. He computed the net *loss* from the operation of the properties as follows [R. 52]:

Gross income from the properties		$370,448.72
Deductions:		
Production expense	$285,390.90	
Development expense	279,927.04	
Total expense		565,317.94
Loss		$194,869.22

NOTE: To this point the Statement is an exact reproduction of the Statement made by the Commissioner at pages 4-5 of his brief in the Court below. The following additional facts (not mentioned by the Commissioner) are also pertinent and material.

Regulations 69 were promulgated under the Revenue Act of 1926 on August 28, 1926. Under Article 223 thereof, such incidental expenses are as paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of an oil and gas property, drilling of wells, building of pipe lines, and development of such property, may *at the option of the taxpayer* be deducted as a development expenditure (in determining taxable net income) or charged to capital account. The Regulations promulgated under Revenue Acts of 1918, 1921 and 1924 provided for the same option. T.-D. 4025, VI-1 Cumulative Bulletin 75.

But the Regulations also provided that an election *once made* under this option will control the taxpayer's returns *for all subsequent years.* Art. 223, Regs. 69; Art. 243, Regs. 74.

In its tax return for the year 1925, the respondent elected to deduct its development expenditures in determining *taxable* net income [R. 53]. At that time the administrative practice, first adopted shortly after the enactment of the Revenue Act of 1921, which was the first Act employing the phrase, "net income from the property," had consistently been that development expenditures should *not* be treated as a deduction in computing the "net income from the property" *regardless* of whether the taxpayer corporation under Article 223 elected to treat such expenditures as deductions in computing taxable income or to charge them to capital. G. C. M. 2315, VI-2 Cumulative

Bulletin 21. This administrative construction had been called to the attention of Congress and approved by it at the time the 1924 and 1926 Revenue Acts were enacted. See *Ambassador Petroleum Co. v. Commissioner*, 81 Fed. (2d) 474, at pages 476-8; also the quotations from Committee Reports set forth in Appendix, *infra*, pp. 15 and 16.

Not until three years after respondent filed its 1925 return did the Commissioner, in his Regulations 74,[4] *first* attempt to add the *new* condition of Art. 221(i) upon which he relies here.[5]

The legislative history of the Revenue Act of 1928 shows clearly that "net income from the property," as used therein, was not intended to have any different meaning from that assigned to *identical* language in the Acts of 1921, 1924 and 1926. See quotations, Appendix, *infra*, pp. 16 to 18, from Senate Report No. 960 and House Report No. 1882 on the Revenue Bill of 1928.

The Board of Tax Appeals held that the Commissioner could not by regulation change the settled meaning of "net income *from the property*" [R. 54-58], and the decision of the Board was affirmed by the Circuit Court of Appeals [R. 75-84].[6]

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[4]Promulgated February 15, 1929.

[5]See first sentence of Note 2, page 9 of petition.

[6]Although not a part of the Record on Appeal, the recomputations submitted to the Board under Rule 50, and upon which its judgments were based, show an increase in the depletion allowance of $163,278.01 for 1929 and $50,960.73 for 1930. Even under the Board's decision, the respondent received no percentage depletion allowance whatever in 1930 with respect to its Buckbee and Crawford properties—cf. R. 52, last line.

Reasons Why the Writ Should Be Denied.

1. The opinion below deals with the 1928 Act. It merely followed the prior decision of the same Court in *Ambassador Petroleum Co. v. Commissioner*, 81 Fed. (2d) 477, involving *identical* language of the Act of 1926. The *Ambassador* case was decided February 5, 1936. The then Solicitor General (now Mr. Justice Reed) declined to apply for certiorari. No explanation is offered as to why the question is deemed more important now than it was in February, 1936.

2. There is no conflict between the decision in the case at bar and decisions in other Circuits—indeed, the Ninth Circuit is the only one which has decided the point.

The petition asserts (p. 11) that the issue here raised "is presented in 107 cases, involving approximately $9,000,000.00 in taxes, now pending before the Board of Tax Appeals and the Income Tax Unit." It fails to inform this Court that the same issue is pending in the Fifth and Tenth Circuits.

Counsel for respondent now has before him copies of the *printed* records filed June 8, 1938 in the Fifth Circuit in two cases of *Commissioner of Internal Revenue v. F. H. E. Oil Company*, Nos. 8800-1, wherein the Commissioner's petitions for review of memorandum decisions of the Board were filed February 12, 1938. The sole issue there involved is identical with that presented here, except that those cases involve the Act of 1932.[1]

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[1]Copies of the records in the Fifth Circuit cases above mentioned have been lodged with the Clerk of this Court, so that they may be inspected if desired.

The Clerk of the Board advises that on June 27, 1938, the Commissioner filed petitions for review by the Tenth Circuit of the decision of the Board in the case of *Ralph W. Crews, et al. v. Commissioner*, reported 37 B. T. A. 387 (No. 57), promulgated February 23, 1938. The *Crews* case involves the Act of 1928.

The decisions which will undoubtedly be rendered during the next six months by the Fifth and Tenth Circuits may well agree with that in the case at bar, in which event there would be no need to burden this Court with deciding the meaning of a statutory provision which has appeared in every revenue statute beginning with the Act of 1921. The petition herein is premature.

3. The decision below was correct because (a) the legislative and administrative history of the statute and three prior revenue acts permits no other conclusion; (b) the same considerations which impelled this Court to construe the phrase, "gross income from the property" (upon which the percentage depletion allowance is *primarily* based), to mean gross *operating* income,[8] require that the phrase "net income from the property" be construed to mean net *operating* profit—as it was prior to 1929;[9] (c) it would be grossly inequitable to change the long-existing rule upon which the taxpayer relied in making its election in 1925, especially where the Commissioner is holding the taxpayer to the *burdens* of such election.

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[8]Cf. *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312; *Helvering v. Mountain Producers Corp.*, ... U. S. .....; *Helvering v. Elbe Oil Land Development Co.*, ... U. S. ....., the last two decided March 7, 1938.

[9]See Appendix, *infra*, pp. 15 to 18, as to the legislative and administrative history.

Every contention now advanced by the Commissioner was rejected by the Treasury in its *original* consideration of the meaning of "net income from the property" in the 1921 Act. The attempted change of administrative practice, as first officially reflected in Regulations 74, was undoubtedly induced by G. C. M. 2315, *supra*, promulgated September 26, 1927, which was expressly based upon the erroneous premise that "net income from the property," as used in the percentage depletion allowance provision, meant the same thing as the statutory "net income" to which the tax rate applied. The reasoning of *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312, has since demonstrated the fallacy of the premise, but the Commissioner has not corrected the erroneous conclusion which resulted therefrom.

4. Contrary to the assertion made at page 11 of the petition, it is obvious that the question here involved does *not* arise "in every case where percentage depletion is claimed." It can arise *only* where the intangible development expenditures, when added to production expense, exceed 45% of the "gross income from the property." The question does not arise where development expenditures have been capitalized, as in *U. S. v. Dakota-Montana Oil Co.*, 288 U. S. 459. Nor does it arise where the development expenditures are incurred in one taxable year and production of oil is first obtained in the succeeding taxable period; in such a case, which is not uncommon, the taxpayer would be required, by reason of its binding election made in 1925, to charge off the development expenditures

in the year made, with little or no benefit for tax purposes. In the case at bar the taxpayer operated eleven oil properties during the taxable years [R. 49]—yet the question arises as to only three of the properties for 1929 and only two[10] for the year 1930 [R. 50].

Conclusion.

No conflict of decisions in the Courts below has been shown, and the decisions of the Board and the Circuit Court of Appeals herein are correct. The question is involved in appeals now pending in the Fifth and Tenth Circuits, and the determination of the necessity for clarification by this Court may well await the decisions of those Circuits. The petition should be denied.[11]

Respectfully submitted,

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August 15, 1938.

---

[10]See Note 6, *supra*, p. 10.

[11]The question here presented certainly cannot compare in importance with that involved in *Hamersley v. United States*, certiorari denied, 300 U. S. 659. Yet in that case (No. 564, October Term, 1936) Solicitor General Reed, while expressly conceding that the case presented a question of importance, nevertheless contended—successfully—that the petition should be denied because no conflict of decisions in the courts below had been shown and the decision of the Court of Claims was correct.

APPENDIX.

1924 Act:

Report of Committee on Ways and Means on the Revenue Bill of 1924 (H. Rep. No. 179, 68th Congress, First Session, p. 18):

> "(10) The last part of subdivision (c) supersedes the second and third provisos of section 214 (a)(10) and 234(a)(9) of the existing law. The existing law limits discovery depletion to the *operating profit* from the property upon which the discovery is made. The bill limits discovery depletion to 50 per cent of the *operating profit* upon which the discovery has been made."

Report of the Senate Finance Committee (S. Rep. No. 398, 68th Congress, First Session) contains a similar statement at page 20.

NOTE: "Operating profit," the term used by both Committees, had been defined in Art. 201(f) of Regulations 62, under the 1921 Act, as "the net income from mineral production before depletion and depreciation are deducted. It is distinct from net income." Compare definition of "operating profit" in Art. 221 (f) of Regs. 74, *supra*, p. 5.

1926 Act:

Report of Committee on Ways and Means on Revenue Bill of 1926 (H. Rep. No. 1, 69th Congress, First Session, page 6):

> "The discovery depletion deduction limitation of an amount not in excess of 50 per cent of the net income of the taxpayer from the property upon which the discovery was made, provided in existing law, is retained in this provision."

Report of Senate Finance Committee (S. Rep. No. 52, 69th Congress, First Session) contains a similar statement at page 17.

The Conference Report (H. Rep. No. 356, 69th Congress, First Session) contains a similar statement at page 32.

NOTE: The foregoing reports show: (a) that the 68th Congress knew that "net income from the property," as used in the 1921 Act, had been construed to mean "operating profit" and intended the similar phrase in the 1924 Act to be given the same meaning; (b) that although the 69th Congress originated the percentage depletion allowance in 1926, it nevertheless intended that "net income from the property" should have the same meaning as in the Acts of 1921 and 1924.

1928 Act:

When the 1928 Revenue Act was passed the principal change over the earlier law was a rearrangement of the various sections involved. No change was made with respect to the depletion allowance. A careful study of the Committee Reports on the 1928 Bill fails to reveal any comment on the depletion allowance in so far as the phrase "net income from the property" is concerned. A change was made with respect to the allowance for depletion where property is held by one person for life with remainder to another, and in case of property held in trust, and provisions were inserted in the 1928 Act to cover this situation. See Section 23 (1), Revenue Act of 1928. These

changes originated with the Senate Finance Committee. The Senate Finance Committee Report (S. Rep. No. 960, 70th Congress, First Session, page 20), contains the following:

> "Sec. 23(k) and (l) Depreciation and Depletion—Life Estates and Trusts—The House *bill makes no change in existing law* with respect to these deductions. The Committee proposes to amend and clarify the law governing the manner in which the deductions shall be apportioned as between life tenant and remainderman or trustee and beneficiary. There is uncertainty and considerable hardship *in these two classes of cases* under the existing law.
>
> "In the case of life tenant and remainderman the bill provides that deduction for depreciation shall be computed as if the life tenant were the absolute owner of the property. * * * In the case of property held in trust, the allowable deduction is to be apportioned between the income beneficiaries and the trustees in accordance with the pertinent provisions of the will. * * * The bill contains similar provisions as to deductions for depletion."

The Conference report on the 1928 Revenue Bill (H. Rep. No. 1882, 70th Congress, First Session, page 11), recognizes this change as follows:

> "Amendment No. 30: Under existing law difficulty has been experienced in determining and allowing the deduction for depreciation in cases where property is held by one person for life with remainder to another person; and the deduction in the case of property held in trust, is allowable only to the trustee. The Senate amendment provides that a life tenant, for the purpose of this deduction shall be considered as the absolute owner; * * * in the case of prop-

erty held in trust the allowable deduction is to be apportioned between the income beneficiary and the trustee in accordance with the pertinent provisions of the will. * * * The bill contains similar provisions as to deduction for depletion. The Senate amendment provides for an equitable apportionment in the deduction of this case. And the House recedes.

"Amendments Nos. 31 and 32. The purpose and effect of these amendments, which relate to the deduction for depletion in the case of property held by one person and remainder to another person, and in the case of property held in trust, is similar in effect to amendment No. 30. And the House recedes."

Thus, the Committees had the depletion provisions called particularly to their attention when drafting the 1928 bill, and made changes in the provisions relating to depletion in so far as they affected life tenants and trusts, but they failed to make any other change in the section. In fact, the Senate bill states specifically that the House bill makes no change in existing law with respect to depletion deductions. The inference to be drawn is that Congress in adopting the 1928 Act approved the section as it stood under the earlier law and approved the interpretation that had been previously placed thereon, intending that except for the changes made, the provisions relating to depletion should remain unchanged.